

## **Expert Rebuttal Report of Stephen E. Siwek**

**On Behalf of**

**Securus Technologies, Inc.**

**WC Docket No. 12-375**

**April 22, 2013**

### **1.0 Introduction and Background**

- 1.1 My name is Stephen E. Siwek. I am a Principal at Economists Incorporated, a research and consulting firm with offices in Washington D.C. and in San Francisco. I submitted an expert report on March 25, 2013 on behalf of Securus Technologies, Inc. (“Securus”) which was previously filed in this Docket.<sup>1</sup> My background and qualifications are set forth in my prior report.
- 1.2 I have been asked by counsel for Securus to respond to the March 25, 2013 Declaration of Coleman Bazelon (“Bazelon Declaration”), also filed in this Docket. My response covers three areas: competition among firms providing Inmate Calling Service (“ICS”); Dr. Bazelon’s proposal that the price of interstate ICS calls be capped at \$0.07 per minute; and the social gains that Dr. Bazelon alleges would flow from his proposal.

### **2.0 Service Provider Competition**

- 2.1 Dr. Bazelon provides a distorted picture of competition among ICS providers such as Securus. His mistaken conclusion that ICS providers receive excess profits is the foundation for other defects in his report.
- 2.2 ICS providers typically are awarded a contract to provide services at a prison after a competitive bidding process. As Curtis Hopfinger states in his Declaration, 4-5 rival firms submit bids for state prison contracts and 5-7 submit bids for non-state contracts.<sup>2</sup> Each firm submitting a bid would prefer a larger profit over a smaller profit. However, each also knows that if it submits a bid that is likely to result in revenues higher than its costs (which include a normal competitive profit), it risks being underbid by a rival and thus losing the contract.<sup>3</sup> This is essentially the same process that is used by purchasers in

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<sup>1</sup> Expert Report of Stephen E. Siwek on Behalf of Securus Technologies, Inc., Federal Communications Commission, Rates for *Interstate Calling Services*, WC Docket No. 12-375 (“Siwek Report”).

<sup>2</sup> WC Docket No. 12-375, Declaration of Curtis L. Hopfinger Para. 4 (Mar. 25, 2013) (“Hopfinger Declaration”).

<sup>3</sup> Dr. Bazelon acknowledges that a normal competitive profit is a legitimate cost. “Only if the prices of goods and services were related to their costs—broadly defined to include all costs, *including competitive profits* and any non-market externalities—then they would send the right signals that encourage resources to be used efficiently.” Bazelon Declaration, Para. 37, emphasis added.

many industries to obtain the goods or services that the buyer prefers at the lowest possible price.

- 2.3 In the competition for many ICS contracts, the costs which an ICS provider must factor into its bid include site commissions paid to the prison.<sup>4</sup> Site commissions are sometimes a fixed amount paid at the time the contract is awarded (“signing bonus”) or paid monthly or annually. In other cases, the commissions are paid as a specific percentage of gross revenue, sometimes with a guaranteed minimum level of payment.<sup>5</sup> In each case, the site commissions are specified in the contract between the prison and the ICS provider.
- 2.4 A site commission is a cost to an ICS provider, not a form of provider profit. Each rival bidder faces competitive pressure to ensure that its revenues are set no higher than its site commission and other costs (including a normal competitive profit). If an ICS provider were to offer a bid that would earn excess profits, it would risk losing the contract to a rival bidder.
- 2.5 Repeatedly, Dr. Bazelon states or implies that ICS providers receive excess profits. For instance:
- “The service provider then shares those profits with the prison as an incentive to be chosen as the monopoly provider.”<sup>6</sup>
  - Dr. Bazelon claims that prison phone rates reflect a component for “Excess profit for carrier.”<sup>7</sup>
  - Dr. Bazelon states, “The only beneficiaries of the current high rates are the current service providers and the penal institutions that receive commissions from the service providers they contract with.”<sup>8</sup>
- 2.6 These statements are simply wrong. ICS providers receive a competitive profit which is the difference between revenues and all costs, including the cost of site commissions. Revenue which the ICS provider pays to a prison is not “profit” to that provider. Site commissions are not the sharing of ICS providers’ profits. Competition at the bidding stage ensures that ICS providers do not receive excess profits. What Dr. Bazelon calls “current high rates” do not benefit (i.e., do not provide excess profits to) ICS providers.

### **3.0 Bazelon’s \$0.07 Solution**

- 3.1 Dr. Bazelon proposes that the price of interstate ICS calls be capped at \$0.07 per minute for debit and collect calls, with no set-up or per-call fees.<sup>9</sup> He explicitly states that his

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<sup>4</sup> Hopfinger Declaration, Para. 21.

<sup>5</sup> See Siwek Report, Appendix 2.

<sup>6</sup> Bazelon Declaration, Para. 7, emphasis added.

<sup>7</sup> Bazelon Declaration, Para. 12, emphasis added.

<sup>8</sup> Bazelon Declaration, Para. 51, emphasis added.

<sup>9</sup> Bazelon Declaration, Par. 18. Dr. Bazelon also characterizes his proposal as \$0.05 per minute for debit calls and \$0.07 for collect calls. See Bazelon Declaration, Para. 26. I infer that Dr. Bazelon’s proposal refers to interstate calls because he states (Bazelon Declaration, Para. 18) that his proposal is based on an update of an analysis by Douglas A. Dawson, which pertains to interstate rates. See CC Docket No. 96-128, In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996; Petition for

analysis does not cover a “commission for prison.”<sup>10</sup> As explained above, for ICS providers, site commissions which the providers contractually must pay are costs. Dr. Bazelon has nowhere explained how ICS providers could pay these costs under his \$0.07 proposal.

3.2 To better understand how a \$0.07 interstate rate cap would affect ICS providers, consider three cases:<sup>11</sup>

- Some ICS providers paid a site commission fee (“signing bonus”) at the start of their contract. These providers entered their contract anticipating that revenues over the contract term would cover operating costs and the cost of the up-front site commission, leaving the providers with a normal competitive profit. If the price of interstate calls were reduced below anticipated levels, ICS providers would incur a loss equal to the full reduction in interstate call revenues for the remainder of the contract term.
- Other ICS providers pay a site commission fee monthly or annually. These providers entered their contract anticipating that revenues each month or year would cover operating costs and the cost of the site commission, leaving the providers with a normal competitive profit. If the price of interstate calls were reduced below anticipated levels, ICS providers would incur a loss equal to the full reduction in interstate call revenues for the remainder of the contract term.
- Still other ICS providers pay a site commission fee that is a percentage of gross revenues. These providers entered their contract anticipating that revenues would cover operating costs and the cost of the site commission on an ongoing basis, leaving the providers with a normal competitive profit. If the price of interstate calls were reduced below anticipated levels, ICS providers’ revenues would decrease. Because site commissions are paid as a percentage of revenues, the providers’ costs would also decrease, but the cost decrease would be only a portion of the decrease in revenue. For instance, if the site commission were 40%, then a \$10,000 reduction in revenues would result in a \$4,000 reduction in site commission and a loss of \$6,000 (\$10,000 - \$4,000) by the ICS provider. To the extent that the revenue decrease caused the commission to fall below a minimum guaranteed level, the ICS provider’s loss would be the entire revenue reduction.

3.3 Dr. Bazelon asserts that a single per-minute rate can be applied to all prisons because “variation in costs at different [prison] facilities has largely been eliminated.”<sup>12</sup> In fact, as I showed in my previous report, costs vary widely across facilities. From among prisons that are not part of a state Department of Corrections, I chose three groups of 10 facilities each: 10 with the highest call minutes, 10 with the lowest call minutes, and 10 around the middle based on call minutes. The average cost per minute varied from \$0.17 in the highest call volume group to \$0.50 in the middle group and \$1.71 in the lowest call

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Rulemaking or, in the Alternative, Petition to Address Referral Issues In Pending Rulemaking, Declaration of Douglas A. Dawson in Support of Petitioners’ Alternative Proposal, Para. 4 (Feb. 16, 2007).

<sup>10</sup> Bazelon Declaration, Para. 12.

<sup>11</sup> Of course, if there is a facility at which the price of interstate calls is already below Dr. Bazelon’s proposed cap, there would be no revenue reduction.

<sup>12</sup> Bazelon Declaration, Para. 10.

volume group.<sup>13</sup> Obviously, the cost structures continue to vary. Even if an interstate rate cap of \$0.07 per minute would cover the costs of a few facilities, it would not cover the costs of all facilities.

## **4.0 Elasticity**

- 4.1 Dr. Bazelon also claims to have evidence about the elasticity of demand for prison phone calls.<sup>14</sup> He states that the prices of prison calls in New York fell by 57.5% and that usage increased by 36% and that these imply a relatively inelastic demand of -0.63. In fact, the 57.5% reduction does not apply to the relevant time period. According to the December 2007 source Dr. Bazelon cites,<sup>15</sup> the increase in phone usage occurred in April-September 2007. Prices were reduced in April 2007, and reduced again in October. The 36% increase in usage that occurred in April-September could not have resulted from a 57.5% decrease because part of the decrease did not occur until after September. Even within his overly simplistic calculation, Dr. Bazelon has understated the elasticity of demand (or, equivalently, overstated the degree to which demand is inelastic). Dr. Bazelon uses the wrong figure for his calculation: The price reduction in the relevant period was actually **50%**, so the correct calculation would be  $36\% / -50\% = -0.72$ .
- 4.2 Even if this mistake were corrected, a reliable estimate of demand elasticity cannot be drawn from a single observation. In addition to using more observations, a reliable estimate would also use statistical techniques such as regression analysis to control for other factors that could affect call usage, including prison population, prison regulations on phone usage, the distance between prisoners and their home communities, and seasonal factors. It is also possible that the elasticity of demand depends in part on the level of prices before a change and on the magnitude of the change. Stated differently, the elasticity of demand may not be constant along the entire demand curve.
- 4.3 Suppose that the demand for ICS calls is inelastic, as Dr. Bazelon claims. This would guarantee that ICS providers' profits, which are only at competitive levels to begin with, would decrease with a reduction in phone rates. When demand is inelastic, a reduction in price results in a reduction in total revenue, even taking into account the increase in quantity that results from any price decrease.<sup>16</sup> On top of that, the ICS providers would incur additional operating costs due to the increased number of calls, which would further reduce their profits.

## **5.0 Alleged Social Gains**

- 5.1 Dr. Bazelon asserts that reducing the price of interstate ICS calls would result in reduced recidivism and an increase in social welfare. I address each of these claims in turn.

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<sup>13</sup> See Siwek Report, Table 2.

<sup>14</sup> Bazelon Declaration, Para. 44.

<sup>15</sup> See New York State, "Department of Corrections and Community Supervision," (December 13, 2007) available at: <http://www.doccs.ny.gov/PressRel/2007/phoneratereduction.html> (last accessed March 21, 2013).

<sup>16</sup> For instance, see Paul A. Samuelson and William D. Nordhaus, *Economics* (New York: McGraw-Hill, 2001), p. 72.

- 5.2 Dr. Bazelon cites two sources to support a link between an increase in telephone call usage by prison inmates would reduce recidivism.<sup>17</sup> One source states that “better family and community contacts reduce recidivism rates” while the other “asserts that telephone privileges help inmates maintain family and community ties and facilitate the reintegration of inmates into society upon release from prison.” I note that neither source provides any evidence that increasing the number or length of inmate phone calls has any link to reduced recidivism, as Dr. Bazelon assumes.
- 5.3 Dr. Bazelon goes on to assert, “This social benefit of reductions in recidivism rates is difficult to quantify accurately, but it must be large.” He then estimates the reduction in prison costs that would result from a 1% reduction in recidivism. But he has provided no evidence that increased interstate call usage would result in any measurable reduction in recidivism, much less a 1% reduction.
- 5.4 Dr. Bazelon also asserts that reducing the price of ICS calls would improve social welfare by reducing “dead weight loss” resulting from a difference between prices and costs.<sup>18</sup> He claims that interstate ICS prices are above costs, which would cause inmate phone usage to be lower than the socially optimal level. I demonstrated above that there is no reason to believe that ICS prices are above costs that include site commissions and a normal competitive profit. Dr. Bazelon really means that interstate ICS prices could be lower if there were no site commission costs that ICS providers needed to cover. It is the elimination of site commissions that could potentially reduce interstate ICS prices and reduce dead weight loss.
- 5.5 An assessment of the social welfare effects of such a move must go beyond the effects on dead weight loss. Dr. Bazelon states that eliminating site commissions would reduce prison revenues nationwide by over \$100 million.<sup>19</sup> The welfare effects of the proposed rate cap would depend on what would be done in response to this revenue shortfall. Dr. Bazelon suggests that the shortfall could be covered by an increase in general tax revenues.<sup>20</sup> This is by no means certain, especially in view of the difficulty that many states and communities already have in raising enough tax revenues to cover existing services. Prisons might be forced to reduce costs to make up for the decreased revenues. Prisons might respond by confining inmates to their cells to reduce personnel costs of supervision. They might reduce the quality of amenities provided to prisoners, such as food and recreational opportunities and job training and placement. Some of the site commissions that would be eliminated are currently used to compensate crime victims.<sup>21</sup> Given the variety of possible responses to the revenue reduction, it is not at all clear that society as a whole—or even the inmates themselves—would be better off if ICS phone rates were reduced through an elimination of site commissions.

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<sup>17</sup> Bazelon Declaration, Para. 47.

<sup>18</sup> Bazelon Declaration, Paras. 38, 43, 54.

<sup>19</sup> Bazelon Declaration, Para. 52.

<sup>20</sup> Bazelon Declaration, Para. 52.

<sup>21</sup> Texas law mandates that half of site commission payments be used to compensate crime victims. See Securus Comments, Exhibit 6, Attachment (May 10, 2012).